STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

ILLINOIS-AMERICAN WATER COMPANY **CITIZENS UTILITIES COMPANY OF ILLINOIS** **and CITIZENS LAKE WATER COMPANY**	:	
Petition For Approval of Proposed Reorganization and Affiliated Interest Agreements, Issuance of Common Stock and Debt Securities and Assumption of Affiliated Interest Agreements	:	**Docket 00-0476**

BRIEF ON EXCEPTIONS OF ILLINOIS-AMERICAN WATER COMPANY

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BRIEF ON EXCEPTIONS OF ILLINOIS-AMERICAN WATER COMPANY

Illinois-American Water Company ("Illinois-American," "IAWC" or the "Company") hereby submits its Brief on Exceptions with respect to the Hearing Examiner's Proposed Order ("Proposed Order") issued on April 10, 2001. The changes to the language of the Proposed Order that are suggested herein are set forth in Appendix "A."

I. INTRODUCTION

Illinois-American agrees with the Proposed Order's conclusion that the Acquisition[1] should be approved, but submits that the Proposed Order (pp. 40-42) should be modified to adopt the SSP. As presently drafted, the Proposed Order: (i) approves the Acquisition in which IAWC would pay an Acquisition Premium of approximately $66.6 million; (ii) requires the recording on IAWC's books of liabilities it does not have or assume for CIACs and advances with the result that the Acquisition Premium is greatly increased from a level consistent with the purchase price and obligations assumed by IAWC under the Agreement; and (iii) adopts an extremely limited

[1] Unless otherwise indicated, the abbreviations used herein are the same as those used in Illinois-American's Initial Brief and Reply Brief.

savings sharing proposal under which shareholders have the opportunity to realize only a fraction of the return "on" and "of" a prudent investment which will produce substantial savings and benefits to ratepayers. Under the Proposed Order's approach, Illinois-American would invest $66 million up front and receive only minimal revenue to cover the cost of the investment, while customers benefit from Savings approaching one-half billion dollars. This approach is patently inequitable.

Unless the Proposed Order is modified to approve the SSP or alternative ratemaking proposal, Illinois-American's ability to raise necessary capital on reasonable terms and maintain a balanced capital structure would be significantly impaired. If the Company is unable to raise capital on reasonable terms, its ability to provide adequate, reliable, safe and least-cost service would be diminished. Illinois-American, therefore, believes that positive findings under 7-204(b)(4) and 7-204(b)(1) of the Act require adoption of the SSP or alternative ratemaking approach. Illinois-American also requests that the Proposed Order (pp. 48-49) be modified to eliminate the requirement that liabilities not assumed by IAWC for CIAC and advances be recorded on IAWC's books for financial purposes. As will be discussed, this requirement unnecessarily increases the level of the Acquisition Premium. Finally, Illinois-American requests that the Commission clarify the requirement stated in the Proposed Order (p. 42) for initiation of a second proceeding to consider methodologies for the measurement of savings.

Illinois-American's proposal treats all parties fairly. It allows ratepayers to share in the financial benefits of the Acquisition as well as improvements in service. It balances this with a fair recovery of a price negotiated at arm's length. It is not easy to achieve an equitable balance among these separate interests. Illinois-American's approach was painstakingly formulated after careful consideration of all of the interests that needed to be accommodated and the various ways of so doing.

II. THE PROPOSED ORDER SHOULD BE MODIFIED TO ADOPT THE SSP

For the reasons discussed below, the Proposed Order's language rejecting the SSP, as set forth at pages 40-42 in Section E, captioned "Commission's Conclusion," should be deleted in its entirety. Appropriate replacement language is set forth in Appendix "A," Section I(A).

A. Summary of the SSP

The SSP, which was proposed as an integral component of the Acquisition, is as follows:

(a) for ratemaking purposes, ten percent (10%) of the savings resulting from the acquisition ("Acquisition Savings" or "Savings") shown by the Company to be included in data for each rate case test year ("Demonstrated Savings") will be assigned to ratepayers;

(b) the annual cost associated with the Acquisition ("Acquisition Revenue Requirement") will be calculated for purposes of the Savings Sharing Proposal, and will be the annual amount which will amortize the balance of the Acquisition Adjustment recorded in Account 114, including carrying cost to be accrued, ratably over a forty-year amortization period, using a "Home Mortgage Method" (as later described);

(c) for ratemaking purposes, the amount of the remaining Demonstrated Savings not assigned to the ratepayers pursuant to subparagraph (a) above ("Net Demonstrated Savings") will be allocated as follows:

- (i) the amount of Net Demonstrated Savings which is necessary to cover the portion of the Acquisition Revenue Requirement that provides a return "of" the unamortized portion of the Acquisition Adjustment ("Annual Amortization Expense") will be assigned to the shareholders;
- (ii) in addition to the amount of Acquisition Savings allocated to ratepayers in subparagraph (a) above, ratepayers will be assigned fifty percent (50%) of the amount, if any, by which the Net Demonstrated Savings exceed the Acquisition Revenue Requirement; and
- (iii) in addition to the amount of Acquisition Savings allocated to shareholders in subparagraph (c)(i) above, shareholders will be assigned the lesser of: (i) the Net Demonstrated Savings remaining after the assignment of Net Demonstrated Savings to shareholders in accordance with subparagraph (c)(i) above; or (ii) the amount of the Acquisition Revenue Requirement

> that provides a return "on" the unamortized portion of the Acquisition Adjustment ("Capital Cost Requirement"). In addition, shareholders will be assigned fifty percent (50%) of the amount, if any, by which the Net Demonstrated Savings exceed the Acquisition Revenue Requirement.

As Mr. Ruckman indicated, Illinois-American proposes that no later than five (5) years from the date of the Order issued in this proceeding, Illinois-American be directed to file either: (i) a report showing that the level of Acquisition Savings reflected in the then-current rates, based on revenue requirement data for the immediately preceding calendar year, is equal to or in excess of the level of Acquisition Savings allocable to ratepayers for that year under the SSP ("Savings Report") or (ii) proposed rates reflecting the level of Acquisition Savings allocable to ratepayers under the SSP. During the amortization period for the Acquisition Adjustment, additional Savings Reports or rate filings would be made at such intervals as the Commission may direct. [IAWC Ex. 2.0, p. 11.] For purposes of the SSP, the Acquisition Revenue Requirement would be allocated among the rate areas of Illinois-American based upon the ratio of the actual level of Demonstrated Savings for a rate case test year to the total-Company Acquisition Savings for the year. [*Id.*, p. 10.]

The purchase price for the Utility Assets is $219,896,000, subject to adjustment after closing to reflect changes in the value of the assets being purchased, such as the investment in capital additions since June 30, 1999. (This price represents that portion of the overall price for all transactions under the Agreement that is applicable to Illinois-American's purchase of the Utility Assets.) As shown in IAWC Exhibit 3.1R, the Acquisition Savings expected to result from the Acquisition are $447,718,893. Under the SSP, a portion of those Savings would be used to pay the Acquisition Revenue Requirement (which amounts to $246,084,000). As shown on IAWC Exhibit 3.6R, the remaining Savings (net of the Acquisition Revenue Requirement) would be allocated under the SSP to customers and shareholders in the amounts of $137,236,647 (68%) and $64,398,246 (32%), respectively.

B. <u>The Proposed Order's Analysis</u>

In rejecting the SSP, the Proposed Order (p.40) states first that "[t]he SSP would inappropriately require ratepayers to compensate Illinois-American for its decision to pay approximately $66.6 million over book value for Citizen's utility assets." In the present case, however, extensive evidence shows that the purchase price for the Utility Assets was developed through arm's-length negotiations, and that the Acquisition will produce Savings that significantly exceed the cost associated with the Acquisition Premium. The evidence shows that the purchase price is the fair market value of the assets and, indeed, that there would be no Acquisition unless IAWC were willing to pay it. [IAWC Ex. 1.0, p. 9; Ex. 4.0, pp. 3-4.] Extensive data was also presented by Mr. Bobba of Merrill Lynch showing that the market price of utility assets can reasonably be expected, under present market conditions, to exceed book value (at multiples substantially higher than that involved here). [IAWC Ex. 6.0, pp. 2-4.] The evidence also shows that the Acquisition will benefit customers in the area served by CUCI as a result of (i) actions to be taken by IAWC to improve operations and service; and (ii) increased efficiencies as measured by the significant level of Acquisition Savings discussed above. [IAWC Ex. 1.0, pp. 9-10.] As discussed above, under the SSP, a portion of the Acquisition Savings is used to pay the Acquisition Revenue Requirement. The remaining net Savings, in the amount of $201,634,893 are split between ratepayers (68%) and shareholders (32%). [IAWC Ex. 3.0R, p. 9.]

The SSP would allow the Company to bring these Savings to customers with no risk of an adverse rate impact. As Mr. Flaherty, Mr. Gloriod and Mr. Ruckman discussed, the SSP can have no adverse impact on rates at any time. In rate orders issued for the combined Company, ratepayers would be assigned at least ten percent (10%) of the Demonstrated Savings. Recovery of the Acquisition Revenue Requirement would be allowed under the SSP only to the extent of ninety percent (90%) of the Demonstrated Savings. Mr. Stafford gave an example which illustrates the impact of the Acquisition and SSP: if a monthly water bill prior to the Acquisition is $30 per customer and Acquisition-related savings are $10 per customer per month, the customer will realize a $1 reduction in his monthly bill (10% of savings). Consequently, the customer's bill, all else being equal, would be $29. The other $9 of savings will go to paying the Acquisition Adjustment, but the customer's bill is still lower than it would have been without the Acquisition. [Tr. 600-01.]

IAWC's proposal would clearly provide customers with lower costs and better service, all at no risk to the customer. [IAWC Ex. 2.0R, pp. 7-8.] Furthermore, shareholders recover a portion of the Acquisition Revenue Requirement only to the extent that the level of Demonstrated Savings is adequate to cover the Acquisition Revenue Requirement. If there are no Demonstrated Savings at all (an extremely unlikely scenario), rates would remain at the stand-alone level, with no possibility under the SSP that rates could increase as a result of the Acquisition. [*Id.*, p. 9.]

In place of the SSP, the Proposed Order (pp. 40-42) adopts an approach under which no portion of the Acquisition Revenue Requirement is deemed to be recoverable in rates. Under the Proposed Order (pp. 41-42), shareholders are allowed a 50% share of gross Acquisition Savings in rate cases filed within three years from the date of the Commission's Order in this proceeding. No such time limit was imposed in *SBC Communications, Inc.*, *("Ameritech/SBC")*, Docket 98-0555, 1999 WL 1331303 (Ill. CC, Sept. 23, 1999), or *GTE Corp. & Bell Atlantic*

Corp., ("GTE/Bell Atlantic"), Docket 98-0866, 198 PUR 4th 193, 1999 Ill. PUC LEXIS 825 (Ill. CC, Oct. 29, 1999). Also, in the Proposed Order, respective savings shares are determined on a gross basis, without an initial allocation of Savings to shareholders to cover Acquisition Costs.

During the evidentiary portion of this proceeding, IAWC filed IAWC Exhibit 3.6R which showed the relative allocation of net Acquisition Savings under the Company, Staff and IIWC proposals. Late-Filed Exhibit 2 (Attachment 2 hereto) shows the allocation of net Savings that results from the Proposed Order. As Late-Filed Exhibit 2 indicates, under the Proposed Order's approach, the shareholder's portion of gross Acquisition Savings would amount to only $10,289,788 (the sum of $3,747,587 and $6,542,201) of the amount needed to cover the Acquisition Revenue Requirement ($246,084,000). Shareholders receive no net Savings at all. [Late-Filed Ex. 2.] Customers, on the other hand, receive $437,429,106 or approximately 98% of gross Acquisition Savings. [*Id.*] Illinois-American submits that adoption of the Proposed Order's approach would be manifestly unfair to shareholders and would create a significant disincentive to reorganizations, such as this one, that produce substantial savings and other customer benefits.

This Commission does not operate in a vacuum. It must adapt its policies to the current exigencies of the economy and of the various industries that it regulates. In this proceeding, Mr. Kelleher, Mr. Mülle and Mr. Townsley testified extensively with regard to the current state of the water utility industry, the driving forces behind the industry's need to consolidate and the advisability of adoption of a regulatory policy encouraging the consolidation and integration of fragmented water utility operations.

Mr. Kelleher testified that the water industry is the most capital intensive of all the traditional public utility sectors and that it faces huge capital investment costs to replace aging infrastructure and constantly increasing quality standards imposed by the USEPA pursuant to the Safe Drinking Water Act. [IAWC Ex. 5.0, pp. 2-7.] In 1997, the USEPA estimated that the water industry's twenty-year infrastructure investment need was approximately $138 billion. A more recent estimate of the distribution system investment requirements by the American Water Works Association raised this amount to $360 billion, and a report issued by the Water Infrastructure Network in March of 2000 estimated that total water and wastewater infrastructure investment requirements could approach $1 trillion over 20 years. It does not matter which of these estimates is more accurate. The point is that the investment requirements of the water and wastewater industry over the next 20 years for infrastructure replacement, water quality compliance and normal population growth are substantial. [IAWC Ex. 8.0R, pp. 22-23.]

Also, as Mr. Kelleher testified, the industry is a rising cost industry because, in the face of rising costs and capital requirements, per capita customer water usage has remained static due to conservation and environmental ethics. Increased costs cannot, therefore, be offset by rising demand. As a result, the only feasible means for mitigating rate increases dictated by rising costs is the realization of cost reductions that result from synergies occasioned by consolidation and integration of what is now a fragmented industry. [IAWC Ex. 5.0, pp. 6-7.] Each of these cost, investment and usage factors affecting the water industry is applicable to IAWC. As Mr. Kelleher indicates (and as IAWC Exhibit 5.4 shows), IAWC's investment in net plant per customer has steadily increased in recent years, while usage per customer has slightly declined. While future usage per customer is expected to be relatively flat, IAWC expects a continued increase in the level of plant investment per customer. Under these circumstances, it is not reasonable to expect that rate decreases will be possible. However, if the SSP is approved, Acquisition savings will be available to mitigate the level of rate increases which otherwise would be necessary. [IAWC Ex. 8.0R, p. 23.]

The Clean Water Act continues to impact the wastewater side of the business. For instance, regulatory initiatives in Illinois involving new measurement techniques, more stringent ammonia effluent limits, and a Total Maximum Daily Load ("TMDL") on an individual stream basis are among the items that may require significant additional capital investments. The demands for capital are increasing with the demand for higher quality. [Jt. App. Ex. 10, p. 6.] Mr. Townsley's testimony demonstrated that one of the principal benefits to ratepayers of consolidation is high quality water and wastewater service because size and expertise are necessary to achieve that reality. He also testified that, from his perspective of involvement with the water industry, he can verify that AWW is the finest quality water provider in America and that Citizens' customers can only be well served by approval of the sale to an AWW subsidiary. [Jt. App. Ex. 10, p. 2.]

Both in this country and around the world, the water industry has recognized the need to achieve size and economies of scale. There is clear recognition that, if safe and high quality water is to be provided for human consumption, entities of size are needed. Domestically, the same consolidation is occurring as in other parts of the world, as both the industry and regulators have recognized that increased environmental and health concerns can only be addressed by larger entities. [*Id.* at 4-5.]

In past proceedings, the Commission has taken the position that it should approve ratemaking approaches that encourage, not discourage, the acquisition of water utility systems where service improvements or other customer benefits would result from the acquisition. *See e.g.*, *Consumers Illinois Water Company*, Docket No. 88-0045 (Oct. 12, 1988) (where small utility would benefit from service improvements resulting from acquisition by larger utility at a purchase price below book value (resulting in a negative acquisition adjustment), an amount in excess of the purchase price was included in rate base in order not to "create a disincentive" to such acquisitions); *Rollins Water and Sewer Company*, Docket No. 83-0693, 1984 Ill. PUC LEXIS 4 (Ill. CC, Oct. 30, 1984) (where acquisition of small utility at a price below book value (resulting in a negative acquisition adjustment) was found to be in the public interest, an amount in excess of the purchase price was included in rate base to avoid raising a "disincentive or impediment" to such acquisitions). Logically, if this policy is appropriate for small acquisitions, it is even more appropriate in cases, such as this one, where the benefits generated for customers will be much greater.

In cases such as this one, that involve a positive acquisition adjustment (acquisition price above book value), the ratemaking approach that is necessary to avoid creating a "disincentive" or "impediment" to acquisitions that are in the best interest of customers, is the ratemaking treatment proposed by Illinois-American, i.e., providing for the recovery of, and an opportunity for a fair return on, the investment in the acquisition. Many regulatory commissions have adopted the view that ratemaking treatment of the type proposed by IAWC should be approved when: (i) the purchase price for the acquired utility is reasonable and the result of arm's-length negotiations; and (ii) the acquisition provides significant benefits to customers. *See e.g.*, *United Water Idaho, Inc.*, Docket No. UWI-W-97-6, Order No. 27617, 187 PUR 4th 312 (Idaho P.U.C., July 6, 1998) (acquisition adjustment accorded rate base treatment where price ultimately paid was result of arm's-length negotiation and efficiencies of service and improved operations, management and technological expertise for customers resulted); *Virginia, ex. rel. State Corporation Commission v. Po River Water and Sewer Corporation*, 160 PUR 4th 123 (Va.

SCC, Feb. 10, 1995) (positive acquisition adjustment amortized above the line and included in rate base where the purchase price was determined through "arm's-length" bargaining and the "investment was made prudently for the benefit of the customers and the utility"); *Mobile Gas Service Corporation*, 141 PUR 4th 312 (Ala. PSC, April 12, 1993) (acquisition adjustment amortized above-the-line and included in rate base where the "purchase is the result of an arm's-length transaction" and "results in tangible customer benefits"); *Consumers New Jersey Water Company*, BPU Docket No. WR 95050211, OAL Docket No. PUC 05677-95N, 1995 WL 592835 (N.J. B.P.U., Sept. 20, 1995) (where evidence demonstrated benefit of acquisition to customer, Commission allowed above-the-line amortization of positive acquisition adjustment and inclusion of unamortized portion in rate base); *IES Utilities, Inc.*, Docket No. RPU-94-2, 162 PUR 4th 388, 394 (Ia. U.B., May 12, 1995) (acquisition adjustment amortized "above-the-line" and included in rate base where evidence showed that transaction was arm's-length transaction and ratepayer will receive actual quantifiable and non-quantifiable benefits); *Indiana Gas Company, Inc.*, 89 PUR 4th 416, 423-25 (Ind. U.R.C., Jan. 20, 1988) (acquisition adjustment amortized "above-the-line" and included in rate base where evidence showed that transaction would produce cost savings and other benefits); *Jacksonville Gas Corp.*, 40 PUR 3d 372, 374 (Fla. PUC, Sept. 12, 1961) (acquisition adjustment amortized "above-the-line" and included in rate base where transaction was result of arms-length bargaining and constituted a prudent investment).

As Mr. Flaherty explained, regulatory commissions in most jurisdictions recognize that preventing recovery of premiums in all cases would reduce or eliminate investor interest in desirable reorganizations. States traditionally permit the recovery of an acquisition premium when the utility acquired is troubled, badly managed or undercapitalized. [IAWC Ex. 9.0R,

p. 22.] As the Proposed Order (pp. 36-38) indicates, many commissions now, however, also recognize a broader range of public benefits as justifying allowance of premium recovery. These latter cases strike a reasonable balance by providing incentives for consolidations that will benefit both ratepayers and shareholders. Allocation of savings to shareholders provides an incentive for managements to enter into transactions that benefit ratepayers through cost reductions. [IAWC Ex. 9.0R, p. 22.]

As an example, the New York Commission adopted a savings sharing approach in *Joint Petition of Consolidated Edison, Inc., Consolidated Edison Company of New York, Inc., and Orange and Rockland Utilities, Inc.,* ("*Consolidated Edison*"), Case 98-M-0961, 1999 N.Y. PUC LEXIS 109 (N.Y. PSC, Apr. 2, 1999). The Commission recognized the need to adopt savings sharing plans as a means of providing incentives for consolidations that are in the public's interest. The New York Commission explained that:

> [i]t is reasonable in the circumstance of this case to allocate some anticipated savings to shareholders as an incentive for them to take affirmative steps to achieve economies of scale and any other savings they can. While one can assert that these utilities should strive to achieve such savings without any incentives, it is unlikely they will do so, or take the substantial step of merging without sharing in the benefits, and the incentive addresses this.

1999 N.Y. PUC LEXIS 109, at *26. The New York Commission further added that it was not reasonable to limit the sharing arrangement to three years, since it will take a substantial amount of time and effort for the companies to achieve all of the savings they have forecast. *Id.* at *27. Therefore, the Commission stated, in as much as the savings are expected to continue for five to ten years, "it was proper to allow shareholders to retain a portion of the savings during the initial five years", provided rate increases can be avoided. *Id.* Furthermore, the Commission concluded that the public interest was protected. *Id.*

In its Initial Brief (pp. 22-27), Illinois-American discussed *Consolidated Edison* and numerous other orders in which regulatory commissions from jurisdictions other than Illinois have adopted savings sharing proposals. A review of these orders demonstrates that there is no one savings sharing formula that is appropriate for all cases. Rather, in allocating savings, regulatory commissions consider factors such as the investors' need for "a reasonable opportunity to recover the premium included in their investment . . . without which there would be no merger savings." *Entergy Corp.*, 146 PUR4th 292, 330 (La. PSC May 3, 1993). *See also Western Resources, Inc.*, 197 PUR4th 175 (Kan. SCC, Sept. 28, 1999) (plan should consider, inter alia, "expectations of investors"); *UtilCorp. United, Inc.*, Docket 99-WPEE-818 RTS, 198 PUR4th 397 (Kan. SCC, Jan. 19, 2000) (plan should recover acquisition premium to the extent that savings are demonstrated).

In adopting the proposed sharing plan, however, the Proposed Order (p. 42) references no such factors. One factor which affects the value of utility property (and, therefore, the amount of an acquisition premium), for example, is the amount of savings that will flow from acquisition of the property. [IAWC Ex. 4.0R, p. 8.] This amount is, of course, dependent, in part, on the length of time during which savings will be generated and retained. In the present case, there is no basis at all to suggest that the Acquisition will generate Savings for only three years. (*See* IAWC Exhibit 3.1R, which details Acquisition Savings to be realized over forty years.) As a result, the Proposed Order's sharing plan should be rejected as was the proposed three-year plan in *Consolidated Edison*. In this case, the evidence shows that substantial Savings will be produced over at least forty years.

The Proposed Order's sharing plan fails to consider, not only the level of Acquisition Savings and period during which Savings will result, but also issues of cost-recovery and fairness. As shown on IAWC Exhibit 3.6R, the Acquisition Revenue Requirement is $246,084,000 over a forty-year period. The Proposed Order, however, makes no findings at all about the extent to which the sharing plan provides an opportunity to recover the Acquisition Revenue Requirement, without which there could be no Acquisition. Furthermore, Late-Filed Exhibit 2 shows that almost none of the Acquisition Revenue Requirement would be recoverable under the Proposed Order's terms. (As noted above, the shareholder portion of Savings amounts to only $10,289,788.) Under the Proposed Order's approach, shareholders would pay the full cost of the Acquisition, and recover no portion of the net Savings. [Late-Filed Exhibit 2.] In other words, shareholders would pay $235,794,212, so ratepayers could receive $437,429,106, which amounts to a subsidy of customers by shareholders.

This situation is comparable to one in which a utility prudently invests funds in an item of plant, say an energy efficient pump, in order to reduce operating costs (for energy purchases). If the regulatory commission were to adopt the Proposed Order's approach, it would, for ratemaking purposes, disallow in its entirety the cost associated with the plant investment (despite its prudence) and, at the same time, pass on the reduced energy costs to customers through rates. It should be apparent that such a result is inequitable and inappropriate as a matter of regulatory policy. In the water industry, unlike other utility industries, rates are flat or declining, while necessary capital investment continues to increase. Water utilities, however, cannot look to growing revenue as a source of funds to cover higher capital costs. Under the Proposed Order's approach, Illinois-American would be required to invest millions of dollars of capital, with no source of cash flow to pay the related capital costs. Meanwhile, near one-half billion dollars of savings would be reflected in customer rates.

As Mr. Mülle explained, shareholders will balk at making otherwise desirable and economic combinations of operating properties if there is a lack of incentive and they are required to bear the entire burden of the disposition of the Acquisition Adjustment. Investors are "risk averse," and require a return commensurate with the risk they are being asked to assume. A savings sharing arrangement is the best solution to reconciling the market required price levels of acquisitions with the original cost basis of regulation, but its parameters should be closely defined by the anticipated savings and the cost of the acquisition. The SSP is just such a plan and, as Mr. Hartnett and Mr. Mülle indicate, one under which the price paid for the Acquisition is consistent with the savings to be received by shareholders and consumers alike. [IAWC Exs. 4.0R, pp. 4-5 (Hartnett); 8.0R, p. 4 (Mülle)]. As shown in IAWC Exhibit 3.6R and in Late-Filed Exhibit 2 (Attachment 2), of the $447,718,893 total savings projected over the next forty years, the customers receive the first 10% of Demonstrated Savings each year, or approximately $44,771,889 over forty years. The Acquisition Revenue Requirement is $246,084,000, resulting in net available Savings of $201,634,893. In addition to the first 10% of available Savings, customers have the opportunity, under the SSP, to realize additional Savings in the amount of $92,464,758, bringing the total potential Savings for customers to $137,236,647 or 68% of the total available net savings. Provided that Savings are adequately demonstrated to exist in rate cases, the shareholders have the opportunity, under the SSP, to realize net Acquisition Savings of $64,398,246 or 32% of the amount available. Under the SSP, customers and shareholders each receive a reasonable portion of the available net savings. [IAWC Ex. 8.0R, pp. 4-5.] These results stand in stark contrast to the Proposed Order's approach under which shareholders receive no net savings at all.

Adoption of the SSP is supported not only by sound regulatory policy, but also by Illinois law. The courts have previously been faced with arguments similar to those offered by Staff and IIWC in this case offering various technical justifications to force an Illinois utility to suffer the fate of bearing costs prudently incurred to generate savings for ratepayers, while passing the gross savings on to the ratepayers. As will be discussed, the courts have invariably seen through such efforts and ordered that the utility must be reimbursed for prudently-incurred costs expended to generate the savings and that only the net savings can be passed on to ratepayers.

The legal requirement that utilities be permitted to recover prudently incurred costs that benefit customers either directly or indirectly applies no less to acquisition-related costs than it does to other costs. In *United Cities Gas Co. v. Illinois Commerce Commission*, 225 Ill. App. 3d 771, 783, 587 N.E.2d 581 (4th Dist. 1992), the Illinois Appellate Court overturned a rate order in which the Commission disallowed recovery by United Cities Gas Company ("United Cities") of the costs of a "consulting and noncompete agreement" entered into by United Cities in connection with its acquisition of Union Gas Company, noting that the evidence in that case showed that "[t]he entire acquisition transaction, which encompassed the consulting and noncompete agreement as one of its integral parts, resulted in significant cost savings to United Cities' Illinois ratepayers." *Id.* at 777-78. The Court, therefore, reversed the Commission's decision to disallow recovery of the cost of the agreement, holding that "the amount which United Cities expended to secure this agreement is a legitimately incurred cost of service which it is entitled to recover in its rates." *Id.* at 778. The court also stated that, since the acquisition costs will result in "significant cost savings to United Cities' Illinois ratepayers" they are, therefore, also "legitimately incurred costs of service." *Id.* As the decision in *United Cities* indicates, the fact that costs are incurred in connection with an acquisition which will produce substantial benefits for Illinois-American's customers supports the allowance, not the disallowance, of such costs. In fact, there is no evidence that ratepayers would have an opportunity to receive even a portion of the $201,634,893 total net Savings available for customers other than as a result of the Acquisition.

Also, in *Archer-Daniels-Midland Co. v. Illinois Commerce Commission*, 184 Ill. 2d 391, 704 N.E. 2d 387 (1998), the utility, in order to reduce the cost of fuel to its customers, incurred costs of (i) a $70 million payment to a coal supplier in order to buy out of an uneconomic coal supply contract, and (ii) associated carrying costs. Before the Commission, Staff argued that these costs would have to be borne by the Company because only costs of fuel could be passed through the fuel adjustment clause and these were costs for not receiving fuel. *Archer-Daniels-Midland Co.*, 184 Ill. 2d at 395. The Commission ruled in favor of the Company, but, the intervenors appealed. The Supreme Court stated that the utility would have been free to leave the existing uneconomic coal supply contract unaltered, but that the utility had engaged in "prudent purchasing" practices by monitoring its contract and seeking to change it when it became disadvantageous to its customers. *Id.* at 399. The Court held that this is precisely the type of prudent practice that ought to be encouraged and that disallowing the flow-through to ratepayers of the buy out payment and associated carrying costs would create a disincentive for utilities to engage in prudent purchasing practices. *Id.* at 400. *Archer Daniels-Midland* is directly analogous to the situation in the instant case.

In another case involving the recovery of costs incurred to generate savings, *Central Illinois Public Service Co. v. Federal Energy Regulatory Commission*, 941 F.2d 622 (7th Cir. 1991), the utility incurred substantial expenses in prosecuting certain litigation which resulted in a $25 million settlement in favor of the utility. The Federal Energy Regulatory Commission

("FERC") ruled that the utility could not recover its litigation expenses before distributing the settlement proceeds to ratepayers. *Id.* at 630. The court indicated that FERC somehow believed that, by deducting its litigation expenses prior to distributing the proceeds, the utility was attempting "to recover such costs through the fuel adjustment clause," whereas, without a special FERC variance, only fuel costs are eligible to be passed through the fuel adjustment clause. *Id.* The court held that the company had done nothing of the sort, but had merely sought to recoup the expenses it reasonably incurred in the prosecution of the seven-year litigation. The court explicitly recognized that, if the utility were unable to recoup its litigation expenses, then an "inequity remains of requiring the shareholders to bear the burden of expenses to obtain a refund benefitting the customers of [the utility]." *Id.* (quoting *Minnesota Power & Light Co. v. FERC*, 852 F. 2d 1070, 1073 (8th Cir. 1988).) "'Equity dictates that the charges of litigation leading to the recovery of [the settlement] proceeds should be deducted from those proceeds accruing to the beneficiaries.'" *Id.* (quoting *Central Illinois Public Service Co.*, 40 FERC at ¶65,120 (1987)).

One of the more troubling aspects of this case is that the Proposed Order disregards the Commission's prior decisions to the same effect. In its decision in *GTE/Bell Atlantic* the Commission stated that "to the extent that costs are incurred to produce savings and are shown to be both reasonable and directly related, netting [of acquisition costs against acquisition savings] is appropriate." *GTE/Bell Atlantic*, Docket No. 98-0866, 1999 Ill. PUC LEXIS 825, at *101. The Commission reached the same conclusions in *Ameritech/SBC*, Docket 98-0555, Order at 149-50.

The Acquisition Adjustment is a prudent investment resulting in reductions in the cost of service and, in this respect, is comparable to expenditures for such programs as employee termination payments, which are prudent expenses of operation incurred in order to generate future savings and are recoverable. *See, e.g.*, *Commonwealth Edison Co.*, Docket No. 94-0065, 1995 Ill. PUC LEXIS 25, at *85-91 (Jan. 9, 1995) (early retirement program costs allowed in rates); *Illinois Bell Telephone Co.*, Docket Nos. 92-0448 and 93-0238, 1994 Ill. PUC LEXIS 437, at *236 (Oct. 11, 1994) (severance and workforce resizing costs amortized and allowed in rates); *GTE North, Inc.*, Docket Nos. 93-0301 and 94-0041, 1994 Ill. PUC LEXIS 436, *56 (Oct. 11, 1994) (severance costs amortized and allowed in rates); *Illinois Power Co.*, Docket No. 89-0276, 1990 WL 488736, at *103-04 (June 6, 1990) (early retirement plan costs amortized and allowed in rates). The Proposed Order also ignores the myriad of cases demonstrating that it has been the policy of the Commission to allow rate recovery of costs incurred to produce operational savings and efficiencies by allowing amortization of such costs over a reasonable period.

1. The Acquisition Adjustment is not a "Transactional Cost"

The Proposed Order (p. 40) suggests that the Acquisition Adjustment should be disallowed on the ground that it is a "transactional cost that is not directly associated with the utility's provision of service" and, therefore, not recoverable under the standards followed in *Ameritech/SBC,* Docket 98-0555 and *GTE/Bell Atlantic*, Docket 98-0866. With regard to this finding, we note first that, based on the principles established in the cases cited above, the Acquisition Premium is a cost prudently incurred for the benefit of customers and is, therefore, recoverable in rates whether or not it is deemed a transaction cost. (*See United Cities Gas v. Commerce Comm.,* 225 Ill. App. 3d, 587 N.E.2d 58 (4th Dist. 1992) (discussed above).

Furthermore, as Mr. Ruckman explained, the Acquisition Adjustment is an asset recorded on the balance sheet. It is a part of the price paid to the Seller for the assets acquired. It is a direct cost of the Acquisition. [IAWC Ex. 2.0R, pp. 2-3.] As Mr. Hamilton of

PricewaterhouseCoopers, indicated, transaction costs do not include the direct investment required by a transaction, including any premium above book value, but rather are the procedural expenses of effectuating an acquisition. Transaction costs are equivalent to the **expenses** described in Paragraph 76, Costs of Acquisition, of Accounting Principles Board Opinion No. 16 entitled Business Combinations. Paragraph 76 of APB 16 states:

> 76. *Costs of acquisition.* The cost of a company acquired in a business combination accounted for by the purchase method includes the direct costs of acquisition. .... However, indirect and general expenses related to acquisitions are deducted as incurred in determining net income.

Transaction costs are the indirect and general expenses of acquiring the asset or stock. Indirect and general expenses are deducted currently for financial statement purposes and the direct costs of the acquisition are capitalized and amortized over an appropriate period. [IAWC Ex. 7.0R, pp. 6-7.]

In addition, the National Association of Regulatory Utility Commissioners 1996 Uniform System of Accounts for Class A Water Utilities (the "Uniform System of Accounts" or "USOA") directly addresses this issue and clearly does not consider the asset acquisition premium as a "transaction cost." The discussion of Account 114, Utility Plant Acquisition Adjustment, paragraph A states:

> [T]his account shall include the difference between (a) the cost to the accounting utility of utility plant acquired as an operating unit or system by purchase, merger, consolidation, liquidation, or otherwise, and (b) the original cost, estimated, if not known, of such property, less the amount or amounts credited by the accounting utility at the time of acquisition to accumulated depreciation, accumulated amortization and contribution in aid of construction with respect to such property.

Illinois-American proposes to properly record the plant Acquisition Adjustment in accordance with the requirements of Account 114 of the Uniform System of Accounts. Thus, it is not appropriate to classify the premium (plant Acquisition Adjustment) that Illinois-American is paying for the Utility Assets as a "transaction cost." [IAWC Ex. 7.0R, pp. 7-8.]

As Mr. Mülle indicated, the Acquisition Adjustment is the collective difference in the value of the assets (i) as formerly carried on the books of the former utility owner at their net original cost <u>when first devoted to public service</u>; and (ii) the purchase price (fair market value) of the assets purchased by the utility now owning those assets. Transaction costs are not assets. Transaction costs are acquiring expenses incurred in executing the transaction and transferring ownership of the assets. The Acquisition Adjustment, on the other hand, is the premium over net book value that the Company is required to provide up front as an investment, in return for the expectation of synergies and Savings to come. The ratepayers share in the anticipated Savings, while assuming no risk at all. The Acquisition costs them nothing "up front" in the form of transaction (or any other cost) and nothing later on. [IAWC Ex. 8.0R, p. 7.]

As Mr. Mülle further explained, the Uniform System of Accounts, as reported in *Water Utility Accounting*, Third Edition, American Water Works Association, 1995, p. 124, specifically defines the Utility Plant Acquisition Adjustment (Account 114) in the manner quoted above. Utility Plant Acquisition Adjustments Account (114) and Other Utility Plant Adjustments Account (116) contain all plant amounts of the accounting company (Acquiror) that exceed net original cost (*Public Utility Economics*, Garfield and Lovejoy, Prentice-Hall, 1964, pp. 86-94). As Mr. Mülle indicated, there are no items of "transaction costs" included in these plant accounts. [IAWC Ex. 8.0R, p. 8.] In this regard, Mr. Mülle's testimony confirms that of Mr. Hamilton discussed above (IAWC Ex. 7.0R, pp. 7-8.)

If, as the Proposed Order (p. 40) maintains, the Acquisition Premium is a transaction cost comparable to the merger fees and expenses referenced in Dockets 98-0555 and 98-0866, the

Proposed Order should further conclude that, as Staff witness Smith admitted, such costs are recorded under the USOA in Account 301, a rate base Account (Tr. 820). The Proposed Order, however, disregards this point. Moreover, as Mr. Mülle indicated, the Acquisition Adjustment is simply a part of the purchase price (the part above Citizens' book value). [IAWC Ex. 8.0SR, p. 4.] Presumably, the other part of the purchase price (i.e., the original cost of the assets) can be reflected in rates. Does the Proposed Order intend to suggest that part of the purchase price is a disallowed "transaction" cost and part of the purchase price is not? If so, the Proposed Order should provide findings to explain its conclusion.

2. The Value of the Utility Assets is Equivalent to the Purchase Price

The Proposed Order (p. 41) concludes incorrectly that the value of the Utility Assets "is their depreciated original cost." In Illinois, the Public Utilities Act, 220 ILCS 5/1-101 et seq., requires that, in establishing rates, the Commission must allow a reasonable rate of return on the "value" of property used in providing utility service. 220 ILCS 5/9-201, 9-211. As stated by the Illinois Supreme Court, " . . . , it is the value of the utility's property devoted to public service upon which the reasonable rate must be returned. It is a <u>value</u> concept and not a <u>cost</u> concept." *Union Elec. Co. v. Commerce Comm.*, 77 Ill. 2d 364, 377 (1979) (emphasis in original). As the Proposed Order (pp. 40-41) recognizes, Section 9-210 of the Act permits the Commission, in appropriate cases, to base its determination of "value" on the original or book cost of property. 220 ILCS 5/9-210. Illinois law, however, also requires that the Commission base its decision on the evidence of record in each proceeding. 220 ILCS 5/10-201; *Choate v. Commerce Comm.*, 309 Ill. 248 (1923); *Ill. Cent. R. Co. v. Commerce Comm.*, 395 Ill. 303 (1946). In this case, IAWC presented extensive evidence indicating that inclusion of the Acquisition Adjustment in rate base "would give proper recognition to the value of . . . [the acquired] property. . . . " [IAWC Ex. 2.0, p. 13.]

The evidence in this case is overwhelming that the purchase price is fair, reasonable and reflects fair market value. The allocated price of the Utility Assets is $219,900,000, a price arrived at by arm's-length negotiations. Also, Mr. Hartnett presented a DCF analysis for the Utility Assets which produced a value of $221,000,000, thereby fully supporting the agreed upon price. [IAWC Ex. 4.1R; IAWC Ex. 4.0R, p. 8.] Staff witness Langfeldt maintained that the Illinois DCF analysis improperly failed to reflect tax benefits related to the transaction and that the analysis did not reflect the same level of Savings as is shown in IAWC Exhibit 3.1R [Staff Ex. 9.00, p. 13.] As Mr. Hartnett explained, however, Ms. Langfeldt is wrong in saying the tax benefits are not included in the DCF analysis. As was explained in the response to Data Request RL 8.02, the DCF analysis was updated to reflect the tax benefits during the negotiations with Citizens. [IAWC Ex. 4.0SR, p. 4.] Furthermore, the fact that the level of savings shown on IAWC Exhibit 3.1R differs from that used in the DCF analysis was clearly explained in the response to Data Request RL 8.04. [*Id.*, p. 4.] The Savings used for the DCF analysis were the preliminary synergies identified during pre-offer due diligence. Additional data was made available after the offer and such additional data was reflected in Exhibit 3.1R. [*Id.*] The Savings used for the DCF analysis are the same Savings as are included in Attachment 4(c)-12 to Staff Data Request 1.02. [*Id.*] Ms. Langfeldt's criticism of the Illinois DCF analysis is, therefore, baseless.

In concluding that the value of the Utility Assets is equivalent to their original cost, the Proposed Order (p. 41) seems to suggest that evidence regarding a valuation of a utility property that is determined by arms-length negotiations and confirmed by a DCF analysis can be disregarded. CUCI, however is entitled to be paid a purchase price for the Utility Assets which is commensurate with the value of the Assets. Like any other property owner, shareholders, not customers, of a utility are entitled to receive the gain realized on the sale of utility property. *See Northern Illinois Gas Company*, Docket 89-0120 (May 31, 1990) (ratepayers do not gain an interest in property owned by a utility by virtue of its inclusion in rate base; inclusion of property in rate base does not constitute "burden" upon ratepayers which legally or equitably justifies depriving shareholders of gain on sale); *Consumers Illinois Water Company*, Dockets 95-0307 and 95-0342, Order on Remand (November 5, 1997) (Order on Remand issued after Appellate Court reversed rate order which transferred gain on sale of water utility property to customers); *Consumers Illinois Water Company v. Commerce Comm.*, Case No. 3-96-0317 (3rd Dist. July 8, 1997)). To deny CUCI's shareholders the gain on the property they devoted to public service would violate the shareholder's due process rights. (U.S. Const. Amend. XIV and Illinois Const. Art. 1, Section 2).

In reaching its conclusion, the Proposed Order (p. 41) also notes that this is not a case in which a large utility is acquiring a small one that was unable to provide service or raise capital. The Proposed Order (p. 41) also states, "[t]here has been no showing that Citizens has been unable to provide safe and reliable service or to raise necessary capital." These findings, however, ignore the benefits from consolidation that are explained in the testimonies of witnesses Kelleher and Townsley as addressed above. The findings also ignore the fact that the Acquisition will benefit customers in the areas presently served by IAWC and CUCI as a result of increased efficiencies and the enhanced strength of the combined entities. Both entities possess excellent technical and management capabilities but, combined, their operational synergies will result in savings, and will allow system-wide selection and implementation of best management practices. The financial strength of the AWW system will assure that both the Illinois-American and CUCI systems will have an enhanced ability to attract capital at competitive rates. The combined companies will also be able more effectively to pursue acquisition of and to manage, operate and maintain small, underfunded water and wastewater systems that cannot readily meet current and future regulatory standards. Under the SSP, customers of the combined company will realize these benefits without any negative rate impact from recovery of the Acquisition Revenue Requirement. In fact, if the SSP is approved, rates will be reduced from the level which would be required for the Companies on a stand-alone basis in absence of the Acquisition. [IAWC Ex. 1.0, pp. 8-9.] Even if there were no non-economic benefits, the SSP should be approved as the Acquisition Savings are substantial.

Adoption of the SSP would provide fair treatment for both ratepayers and shareholders. Where, as here, (i) customers of the acquired utility will benefit, with no adverse impact on the customers of the acquiring utility and (ii) a purchase price greater than the net original cost of the acquired system is reasonable, reflects fair market value, and was arrived at through arm's-length negotiations, fairness requires that the shareholders have an opportunity to recover a reasonable portion of the costs incurred to generate acquisition-related savings to the benefit of customers. A denial of cost recovery would create a disincentive for acquisitions which are in the public interest. [IAWC Ex. 1.0, p. 9.]

In noting that CUCI has provided adequate water service in the past (Proposed Order p. 38), the Proposed Order fails to acknowledge or discuss the implications of Mr. Townsley's testimony indicating that CUCI no longer wishes to be in the water and sewer business and has, therefore, signed the Agreement, under which it will dispose of all water/sewer assets in all States in which it presently operates. As Mr. Townsley explained, due to the concerns expressed by Mr. Kelleher (and discussed above, pp. 7-8), CUC is no longer willing to be in the water and wastewater businesses. Mr. Townsley stated that AWW can address new proposed standards in the water and wastewater business more effectively and cheaply than CUCI because AWW has the expertise to be a far more effective implementer of change and further has the ability to achieve economies of scale. The costs of ubiquitous compliance tasks performed for a larger base of customers by an in-house team of experts would result in a reduced incremental cost. Mr. Townsley also pointed to AWW's nationally-recognized research facilities located in Illinois. [Jt. App. Ex. 10, pp. 7-8.]

Mr. Townsley concluded that, if, as a nation, we are truly serious about the importance of water quality to our own health and that of our families, we must permit the creation of entities that have as their primary business the provision of quality water and wastewater service. If we are going to achieve that quality at a price level that is tolerable, an entity with the size and expertise to do the job is needed. As Messrs. Kelleher and Mülle indicated, permitting the recovery of acquisition adjustments resulting from the need to pay acquisition premiums is the *sine qua non* of a policy encouraging the needed consolidation. [IAWC Ex. 5.0R, pp. 15-16 (Kelleher); IAWC Ex. 8.0R, pp. 4-5 (Mülle), 13.] The Proposed Order does not set forth any findings with regard to the issues which Messrs. Kelleher, Mülle and Townsley discuss.